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ABSTRACT

This self-instructional module on determining capital needs is the third in a set of twelve modules designed for small business owner-managers. Competencies for this module are (1) identify factors which must be considered when you begin the search for additional funds and (2) identify the sources of additional funds. Provided are information sections on estimating money need, where funds can be borrowed, sources of funds, and improving your chances of acquiring additional funds. Also included are two learning activities consisting of worksheets to be filled out to determine the amount of capital needed to operate a business, two pamphlets from the Small Business Administration ("Sound Cash Management and Borrowing" and "The ABC's of Borrowing," which discuss cash budget forecasting and cash flow for repaying a loan), and a script from a cassette tape designed for use with this module. (The final report of this project is available as CE 017 858.) (JH)

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SCRIPT

DETERMINING CAPITAL NEEDS

INTRODUCTION:

Most businesses, whether new or existing, often require capital for various reasons. Leading institutions are eager to lend money to these firms, provided they have shown the potential to be, or are, successful business operators. However, before loan requests are granted lending institutions require detailed kinds of information about the business, including certain financial statements. Let's drop in on Sue Perez, owner of the Yarn Shop and Don Jennings, bank loan officer discussing bank requirements in processing loan requests.

Sue: Dan, I'd like to take you up on your offer of financial assistance Will you help me arrange a loan?

Dan: That's what I'm here for! I think it's safe to assume that your business is progressing quite well.

Sue: I've worked awfully hard in that respect and I'm quite satisfied. Anyway, I'm ready to forge ahead with my expansion idea.

Dan: Sue, I'm sure you worked hard. I promise you it is worth the effort you put into it. What is your expansion idea?

Sue: I've thought very seriously of adding both macrame and decoupage supplies to my line. I've had several customers inquire about these supplies. It appears there's a demand for them. I'll need approximately $2000 to purchase my initial inventory.

Dan: That sounds like a very reasonable request. I'll give you an idea of what information I'll need in order to evaluate your loan request, Sue. I don't anticipate any problem, but I want you to be sure to consider all expenses. First, I'll need a personal financial statement.

Sue: Perhaps this is a silly question, Dan, but why do you require a personal financial statement.

Dan: First, it aids us in judging how you handle your own money, and it gives us an opportunity to determine the assets (personal belongings) which may be used for collateral.

Sue: You mean, then, that I'll have to pledge some of my personal assets.

Dan: Generally, if the loan is to cover a short period of time, say less than a year, we wouldn't require collateral. On the other hand, if you wanted a loan for a longer period of time, in most cases we would have to secure the loan with a pledge of your assets.

Sue: I guess that's fair enough.

Dan: I'm sure you're aware, after attending the Small Business Administration workshop, that one of the primary reasons for small business failures is under capitalization. Most business persons underestimate the amount of money needed to carry them through a particular time period, say a year. On the other hand, they often overestimate their projected sales volume. Even where the chances of success are good we must still portect our depositors against business risks. Really, Sue, the money we lend belongs to them.

Sue: I would certainly want my interest protected, too.

Dan: Apart from your personal financial statement, I'll also need a projected balance sheet and profit and loss statement. Since your husband is an accountant, you may want to work with him on the preparation of these statements. Also, Sue, be realistic in your estimates. Don't underestimate the amount of your loan because you may find yourself short of capital about six months from now. Is $2000 enough?

Sue: I think so.

Dan: Well don't be too conservative.

Sue: Why do you require a projected balance sheet and profit and loss statement?

Dan: It shows us that you have carefully thought out and planned your business operation and expansion, especially your assets and expenses. Also, if your business was new, it would give us an indication of how much you were willing to invest in the business, and what your capital needs would be. (PAUSE) You'll recall earlier that I indicated the tendency of some business owners to underestimate capital needs and overestimate their sales. We're interested in helping you to maintain your present level of business operation.

Sue: I'm all for that. I don't want to undo what has been done. It's taken too much work to get to this point.

Dan: To do things right, it is a little involved, Sue. But I can assure you, it's the only way.

Sue: I guess you're right. You certainly know more about these things than I do.

Dan: I've got a worksheet that you can use as a guide, Sue, in preparing your estimates. It should be quite helpful to you.

Sue: Thanks so much, Dan.

Dan: Do you have any questions, Sue?

Sue: I guess not. I appreciate all the time you've spent with me and the helpful information, too.

Dan: Call me if you have any questions. I'll be glad to work with you.

Sue: OK - Dan - I'll contact you soon. Good-bye.

Dan: Good-bye, Sue. Have a nice day.

CONCLUSION:

Lending institutions want to help small business persons who carefully plan their business operation. Your chances of acquiring additional funds when you need them will be improved if you take the time to prepare a:

1. personal financial statement
2. balance sheet
3. profit and loss statement

Now let's move to page 2 of the module where you will learn more about determining capital needs.

PURPOSE

Many small business owner-managers underestimate the amount of money they will need to maintain their business operation. Because of seasonal fluctuations, unexpected expenses, or business volume that is lower than expected, funds needed to operate the business may not be adequate. Many business firms face financial difficulty during the first few months of operation. The purpose of this module is to examine factors which must be considered when you begin the search for new funds and identify sources of additional funds.

COMPETENCIES

Upon completion of this module, you will be able to:

1. Identify factors which must be considered when you begin the search for additional funds.

2. Identify the sources of additional funds.

INSTRUCTIONS

Before reading the material which begins on page 2, listen to the cassette entitled "Determining Capital Needs."

ESTIMATING YOUR MONEY NEEDS

How much money will you need to stay in business? Many small businesses fail each year because they lack sufficient funds to keep the business operating. Frequently, additional expenses such as an increase in taxes or the cost of supplies require greater cash outlays than was anticipated. Expenses of this nature or unforeseen business commitments can rapidly drain your operating funds. More often than not, additional operating funds may be needed because your business:

1. Was started with insufficient funds. Perhaps you under-estimated the amount of money needed to carry you through the first year.

2. Is not attracting enough customers. Your projected sales for the year were much higher than actual sales, due perhaps to new competition in the area or a weak economic situation.

3. Experiences seasonal fluctuations. Many firms are seasonal in nature. To compensate for this characteristic, you may wish to add an additional line of products or offer other services.

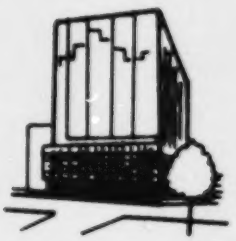
4. Needs to expand to meet consumer demand. You may have to purchase additional equipment or hire additional employees to expand your business.

Many small businesses, for various reasons, require additional operating funds. The remainder of this module is devoted to identifying various sources of funds and illustrating how you can improve your chances of obtaining the money you need.

WHERE CAN I BORROW THE FUNDS I NEED?

Although funds can be borrowed from many sources, it is a sound practice to invest in the business as much of your personal funds as you possibly can. Since your money is interest free, this approach will eliminate or reduce interest expense. Similarly, a sizable personal investment in the business serves as an indication to lending institutions that you have a strong commitment to the success of your firm. They are generally unwilling to lend money to persons who are unable or unwilling to make this sacrifice.

SOURCES OF FUNDS



1. Personal
   a. cash and personal savings
   b. loans on insurance policies
   c. mortgage on your home or other property

2. Commercial Banks
   Excellent source of short-term (one year or less) funds and Small Business Administration Guaranteed Loans

3. Trade Credit
   Credit extended by your suppliers of equipment and merchandise

4. Government Agencies
   Excellent sources of long-term (1-5-10 years) funds
   a. Small Business Administration Direct Loans
   b. Small Business Investment Corporation

5. Small Loan Companies

6. Relatives

IMPROVING YOUR CHANCES OF ACQUIRING ADDITIONAL FUNDS

The ability to obtain funds when you need them is important to the success of your business. Your personal character will largely determine whether your loan request will be accepted or rejected. Lending institutions are eager to make loans to businesses which are well managed, profitable, and growing. However, lending institutions are unwilling to finance 100 percent of your business operation. Loan officers are interested in how much you are willing to invest in your business. In evaluating your loan request, loan officers must be satisfied with answers to the following questions:

1. What sort of person are you? Are you credit worthy? Are you stable? Do you have management ability?
2. What are you going to do with the money? (This frequently determines the type of loan--short or long term.)
3. When and how do you plan to pay it back?
4. Is the amount of the loan sufficient to allow for unexpected developments?
5. What is the outlook for business in general and your business in particular?

To get answers to these questions, the loan officer will carefully interview you and review your business records. For example, suppose you owned a lawn and garden shop and you decided to purchase a new machine that would seed and fertilize lawns at the same time. What information should you provide the loan officer to assist him in his evaluation of your loan request? You should be prepared to:

1. Provide an estimate of sales resulting from the addition of this new service.

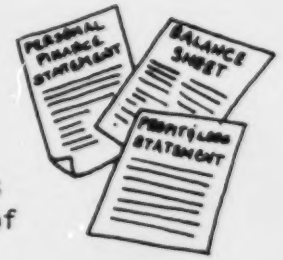
2. Identify any new or additional inventory items required to complement the new service initially, and how often the inventory would have to be replenished.

3. Estimate the working capital needed to maintain this service. Perhaps you will have to hire a new employee to maintain and operate the machine. Additionally, you may have to spend more money to advertise your new service.

4. Determine how much this service will cost, including machine costs, additional equipment, and storage.

So that your chances of obtaining additional capital may be improved, be prepared to present to the loan officer your:

1. Balance Sheet
2. Profit and Loss Statement
3. Personal Financial Statement



Thoughtful preparation of the required estimates and records will not only enhance your chances of acquiring the funds you need, but will speed up the loan process. This is especially vital to meeting your business commitments and maintaining your business operation.

NOTE:
The worksheets which follow can be used by those contemplating going into business or those who want to determine an adequate amount of capital needed to operate a business. To determine the amount of funds you may need to successfully operate your business, fill out the worksheets in their entirety.

NOTE: Please turn to page 5 and complete learning activity number one.

WORKSHEET NUMBER ONE

ESTIMATED MONTHLY EXPENSES (LEARNING ACTIVITY NUMBER ONE)

ITEM	Your estimate of monthly expenses based on sales of $____per year	Your estimate of how much cash you need (see column 3)	What to put in Column 2 (These figures are typical for one kind of business. You will have to decide how many months to allow for in your business.)
	Column I	Column 2	Column 3
Salary of owner-manager	$	$	2 times column 1
All other salaries and wages	$	$	3 times column 1
Rent	$	$	3 times column 1
Advertising	$	$	3 times column 1
Delivery Expense	$	$	3 times column 1
Supplies	$	$	3 times column 1
Telephone and telegraph	$	$	3 times column 1
Other utilities	$	$	3 times column 1
Insurance	$	$	Payment required by insurance company
Taxes, including Social Security	$	$	4 times column 1
Interest	$	$	3 times column 1
Maintenance	$	$	3 times column 1
Legal and other professional fees	$	$	3 times column 1
Miscellaneous	$	$	3 times column 1

COSTS YOU ONLY HAVE TO PAY ONCE

ITEM	Estimated Cash Needed	
	Column 2	Column 3
Fixtures and equipment	$	Fill in Worksheet on page 7 and put the total in column 2.
Decorating and remodeling	$	Talk it over with a contractor
Installation of fixtures and equipment	$	Talk to suppliers from whom you buy these.
Inventory	$	Suppliers will probably help you estimate this.
Deposits with public utilities	$	Find out from utility companies.
Legal and other professional fees	$	Lawyer, accountant, and so on.
Licenses and permits	$	Find out from city offices what you have to do.
Advertising and promotion for opening	$	Estimate what you'll use.
Accounts receivable	$	What you will need to buy more stock until credit customers pay.
Cash	$	For unexpected expenses or loss, special purchases, etc.
Other	$	Make a separate list and enter total.
TOTAL ESTIMATED CASH YOU NEED	$	Add up all the numbers in column 2

WORKSHEET NUMBER TWO

List of Furniture, Fixtures, and Equipment					
Leave out or add items to suit your business. Use separate sheets to list exactly what you need for each of the items below.	If you plan to pay cash in full, enter the full amount below and in the last column.	If you are going to pay by installments fill out the columns below. Enter in the last column your down payment plus at least one installment.			Estimate of the cash you need for furniture, fixtures and equipment.
		Price	Down payment	Amount of each installment	
Counters	$	$	$	$	$
Storage shelves, cabinets	$	$	$	$	$
Display stands, shelves, tables	$	$	$	$	$
Cash register	$	$	$	$	$
Safe	$	$	$	$	$
Window display fixtures	$	$	$	$	$
Special lighting	$	$	$	$	$
Outside sign	$	$	$	$	$
Delivery equipment if needed	$	$	$	$	$
TOTAL FURNITURE, FIXTURES, AND EQUIPMENT (Enter this figure also in Worksheet #1 under "Costs You Only Have to Pay Once.")					$_____

Source: Small Business Administration

NOTE: Please turn to page 8 and review the preferred reading list.

PREFERRED READING LIST

This instructional module is designed to introduce key concepts regarding ways to determine capital needs. For a more in-depth examination of this topic area, study the following preferred readings.

SMALL BUSINESS ADMINISTRATION SMALL MARKETERS AIDS

#147 "Sound Cash Management and Borrowing"

SMALL BUSINESS ADMINISTRATION MANAGEMENT AIDS

#170 "The ABC'S of Borrowing"

NOTE: You have now completed the module requirements. You may wish to review this module or advance to another module.

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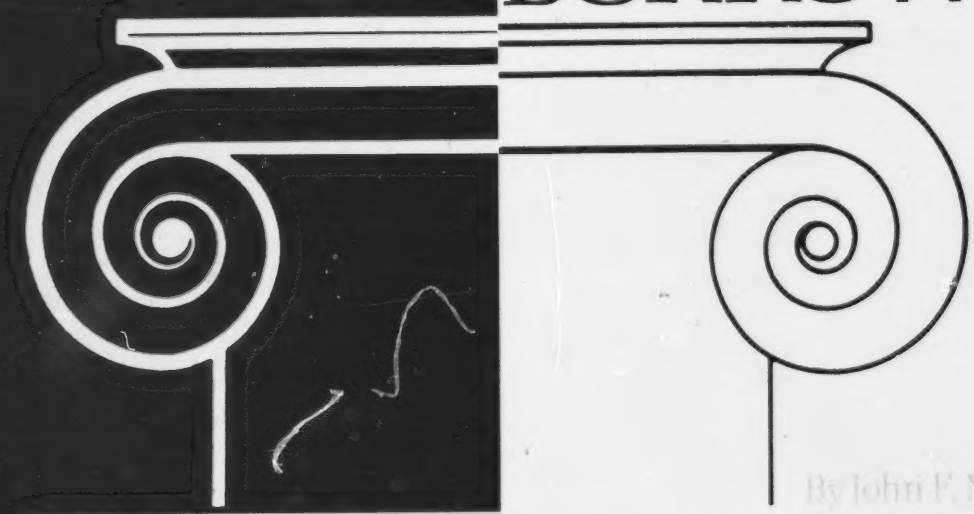
SMALL BUSINESS ADMINISTRATION
SMALL MARKETERS AIDS No. 147
WASHINGTON D.C.

SOUND CASH MANAGEMENT AND BORROWING



By John F. Murphy
Retired bank executive and member of the Manasota SCORE Chapter, Sarasota, Florida

SUMMARY

Poor management is the reason why some owner-managers of small firms have trouble when they try to borrow. Those managers often fail to forecast and plan for cash needs. The resulting business ailment is a "cash crisis."

Sound management must be practiced if loans are to be obtained and used profitably. Such management includes: knowing the firm's cash flow, forecasting cash needs, planning to borrow at the appropriate time, and substantiating the firm's payback ability.

This *Aid* includes examples of the following: a cash budget forecast, a projection of borrowing requirements, and a cash flow schedule for repaying a loan.

IN SPITE OF respectable sales volumes, many owners of small business run into financial trouble. Some get in so deep that they are barely able to pull their heads back above water. Others find themselves only weeks or months away from tacking "out of business" signs on their doors.

Often these men have three things in common. First, they know their line of business. Their technical ability is first rate. Second, they are poor managers. In many instances, they fail to plan ahead because of their enthusiasm for the operating side of their business. In the third place, most of them feel that additional money will solve their problems. They think that a loan will pull them out of the red.

LENDING OFFICER'S VIEWPOINT

Often a bank lending officer refuses, or "declines" the loan request, as it is politely put, of such manager-owners. It is not that he lacks appreciation for the hard work and long hours which these owners put into their businesses. Nor does he question their good intentions.

Foremost in the lender's mind is the question: Can he pay back this loan? Thus, in many cases, he refuses the loan because the owner-manager hastily and haphazardly prepared his application under pressing circumstances. As a result, the lending officer detects an air of instability and lack of planning in the owner-manager's description of his affairs. "How is he really going to repay" the lending officer asks himself, "If he actually doesn't know how much he needs and how he is going to use the money?"

If an owner-manager's request for a loan is turned down, his best bet is to accept the refusal gracefully and look for weaknesses in his presentation. He can correct these weaknesses when applying for a loan in the future.

Reprinted
November 1976

PERTINENT QUESTIONS

The lender needs the answers to several pertinent questions before he can determine whether the borrower can repay the loan. One of these questions is: What does he intend to use the money for?

WHAT KIND OF MONEY? When you consider borrowing, determine what kind of money you need. A business uses four basic types of money in its operations. Your purpose in borrowing will determine the type.

1. TRADE CREDIT. This type of "money" is not borrowed. It is money you owe your suppliers who permit you to carry your fast-moving inventory on open account. A good credit experience is proven evidence of your ability to repay borrowed funds.

2. SHORT-TERM CREDIT. Banks and other lenders will provide this type of money to carry you in your purchases of inventory for special reasons, such as buying inventory for the next selling season. Such loans are self-liquidating because they generate sales dollars. You repay short-term credit in less than a year.

3. LONG-TERM CREDIT. Such loans—for more than a year—are used for expansion or modernization of your business. They are repaid out of accumulated profits. Usually, the evidence for this type of loan in a small business is a mortgage or a promissory note with terms.

4. EQUITY FUNDS. This type of money is never repaid. You get it by relinquishing a part of your profits to an investor. That is, you sell him an interest in your business.

Many owner-managers fail to recognize the difference between the four types of money. You should keep in mind that money borrowed for a temporary purpose should be used in the profit producing areas of your business and will be repaid out of that operation. Equity funds are those which remain in the business and increase the net worth for the owner.

ARE YOUR SALES ADEQUATE? Are you asking for a loan to bolster sagging sales volume? To buy additional stocks of high-volume merchandise which you feel has even greater potential? To create a new image by an over-all advertising campaign?

WHAT IS YOUR RECEIVABLES POSITION? Are your accounts going uncollected and getting old? In effect, do you really need money to carry old accounts?

IS YOUR PROFIT MARGIN ADEQUATE? Are you doing a lot of business and showing a lack of profit thus indicating that expenses are not controlled? Or is your market insufficient? What is your break-even point for profits?

WHAT IS YOUR PLAN FOR REPAYMENT? Do you forecast your cash income and expenditures realistically?

The lender scrutinizes the cash flow of the business to determine whether the owner-manager is providing sufficient cash to meet his firm's obligations. The lender also has to make sure that cash needed for working capital is not being absorbed by the business into other areas of equity and thereby reducing liquidity.

THE "CASH CRISIS"

The experience of counsellors, such as members of SCORE (Service Corps of Retired Executives) volunteers, is that all too often the small business owner feels that his needs are financial when they are actually managerial. In such firms, money can ease the pressure temporarily, but further indebtedness only intensifies the basic problem. Money alone cannot provide the sound management needed to continue the business.

Counsellors to small business owners are continually faced with the "cash crisis" problem. This cash deficiency results from the lack of planning.

A mistake many purchasers of a business make is that they buy something beyond their means. They take possession of a business of some value but without one important asset—sufficient operating cash. When a buyer does not put aside working capital (cash) after he pays for the business, he cannot pay his current bills. When this happens, the rest of the story is easy to foretell.

It is the "cash crisis."

Sound management consists of arranging matters so that current

liabilities are provided for as they become due and hence paid promptly. When such coordination is not present, the result is a constant "cash crisis."

Without a floating supply of cash a business will experience occasional convulsions which distort, confuse, embarrass, and alarm everyone concerned with the enterprise. The owner-manager's employees and suppliers are the first to sense the nervousness of the situation. When they do, they begin to consider their futures in the light of these emergencies.

Lack of cash can drive a firm into bankruptcy even though its products are first rate and its operations are profitable.

AVOID A "CASH CRISIS"

To avoid a "cash crisis" you should determine how much cash your firm needs for its normal operations. Then plan your finances to achieve that goal. The amount of cash which a business will need differs because all businesses are not alike. Usually, for comfort, five to ten percent of a firm's working capital should be in cash.

In a sense, financial planning is what you anticipate your financial statement will show on a specific date and how you intend to get there. A cash forecast will indicate whether your plan of operation is feasible. A budget will indicate the availability of cash at all points of operations.

CASH BUDGETING

When the subject of budgeting comes up, some owner-managers say, "That's for the big fellow. I know what my volume is and my bank account tells me how much money I have." These owners fail to realize that budgeting can help to eliminate errors of judgment made in haste or made on assumptions rather than facts.

The first thing you must know in budgeting is what your anticipated expenses are going to be for the period being budgeted. Then, how much in sales must be generated to pay these expenses? What will be left? You must try to determine the high and low points in your operations in order to provide the adequate amount of cash. A sales analysis of previous periods will indicate when the high and low points occur.

This forecasting helps you to plan for financing the purchase of inventory and for carrying your accounts receivable. Controlling inventory and accounts receivable can help to take the strain off of your working capital.

USES OF A CASH BUDGET. The cash budget is the most effective tool for planning the cash requirements and resources of your business. With it you plan your financial operations—the cash you expect to take in and pay out. Your goal in budgeting is to maintain a satisfactory cash position for any contingency. When used to project the cash flow of the business, the cash budget will:

- Provide efficient use of cash by timing cash disbursements to coincide with cash receipts. These actions may reduce the need for borrowing temporary additional working capital.
- Point up cash deficiency periods so that predetermined borrowing requirements may be established and actual amounts determined to reduce excessive indebtedness.
- Determine periods for repayment of borrowings.
- Establish the practicability of taking trade discounts or not taking them.
- Determine periods of surplus cash for investment or purchase of inventory and equipment.
- Indicate the adequacy of or need for additional permanent working capital in the business.

BE FACTUAL. The important thing to keep in mind in making a cash budget is the word, "cash." Be as factual as you can. Try not to over-estimate sales or under-estimate expenses. Your sales forecast must be as accurate as possible because it is the basis for figuring your cash and expenses.

Use your experience to determine your "cash" sales. In seasonal businesses and those which have high-ticket merchandise, the percent of sales that are for cash will vary from month to month. Account for these ups and downs in each month, if they apply to your business.

A format such as that shown in the box on page 6 of this *Aid* can help you in being factual. This example of a cash budget forecast uses two columns for each month. The second column allows you to insert the actual figures as they occur and helps in correcting mistakes for future forecasts.

SOUND MANAGEMENT — SUCCESS STORY

With sound management a small firm can often achieve a goal by borrowing only a nominal amount. The experience of two partners in a Southeast business provides an example.

They obtained a contract to manufacture and install kitchen cabinets for a large builder. The contract called for installation in 4 months. To meet this deadline, the partners figured that they needed $56,500 in extra working capital.

Because this amount was more than they wanted to borrow, they asked for help from SBA's SCORE program. The SCORE counselor helped the partners to come up with a borrowing requirement of only $16,000. This solution was arrived at by:

1. Arranging with their supplier to ship and bill for the materials monthly over a 3-month period.
2. Contracting with the builder to make an initial payment and 4 monthly payments.
3. Agreeing not to take any drawings from the business until the cash flow forecast indicated it was free and available.

Based on these facts, the partners estimated that during the 5 months (July through November) the firm should take in $88,000, pay out $56,500, and have a balance of $31,500 at the end of November. However, the problem was in July and August when expenses would run far ahead of the firm's income. To determine how a loan of $16,000 including interest could see the firm through these months, the following estimates were made:

Estimate of Borrowing Requirements To Take on Additional Contract

	July	August	September	October	November
CASH REQUIREMENTS					
Inventory	$15,000	$10,000	$ 7,000		
Operating Expenses	4,000	6,000	6,000	$ 4,000	$ 2,000
Extra Equipment	2,500				
Total	$21,500	$16,000	$13,000	$ 4,000	$ 2,000
CASH AVAILABLE					
Cash on Hand	$ 2,000			$ 2,000	$18,000
Collections	10,000	$10,000	$15,000	20,000	31,000
Total	$12,000	$10,000	$15,000	$22,000	$49,000
EXCESS CASH OVER RECEIPTS	0	0	$ 2,000	$18,000	$47,000
ADDITIONAL CASH REQUIRED	$ 9,500	$ 6,000	0	0	0

According to these estimates, at the end of November, the partners would have cash on hand amounting to $47,000. Certain obligations would be outstanding against this cash. The first one would be the repayment of the loan of $16,000. Other obligations would be those which the partners planned to accumulate during the early months of the contract when cash on hand was at a premium, such as reserve for taxes, and the partners' draw.

These estimates convinced the partners that they could perform the contract if they could get a loan. The next step was to convince the bank that their plan was sound.

For the bank lending officer's benefit, as well as their own, the partners projected the loan funds through a cash flow plan for the entire business. The cash flow schedule that was prepared is shown on page 7 of this *Aid*. It showed: (1) that the amount of money requested would be adequate for the firm's need and (2) the margin of cash that was expected to be available both during the contract and at the end of the contract.

RECORDS MIRROR MANAGEMENT

Keep in mind that records are a reflection of the quality of a firm's management. Nobody knows this fact better or uses it more often than a banker.

The efficiency, or lack of it, of an owner-manager portrays itself on the profit and loss statement. The P&L of an effective operation will show adequate profits for the particular line of business. Sales, promotion, expense control, merchandise turnover, and net profit application are the points on which you will be judged.

To determine trends the lender looks at your current financial statement and those for the past several years. The current statement also shows him the makeup of your net worth.

CASH BUDGET FORECAST

	January		February	
	Est.	Actual	Est.	Actual
(1) Cash in Bank (Start of Month)	$1,400	$1,400*	$1,850	$2,090*
(2) Cash in Register (Start of Month)	100	100	150	70
(3) Total Cash [add (1) and (2)]	$1,500	$1,500	$2,000	$2,160
(4) Expected Cash Sales	1,200	1,420	900	
(5) Expected Collections	400	380	350	
(6) Other Money Expected	100	52	50	
(7) Total Receipts [add (4), (5) and (6)]	$1,700	$1,852	$1,300	
(8) Total Cash and Receipts [add (3) and (7)]	$3,200	$3,352	$3,300	
(9) All Disbursements (For Month)	1,200	1,192	1,000	
(10) Cash Balance at End of Month in Bank Account and Register [Subtract (9) from (8)]	$2,000	$2,160	$2,300	

* The owner-manager writes in these figures as they become available.

Cash Flow Schedule—Period of Contract to Repayment of Loan

	July	August	Sept.	Oct.	Nov.
ESTIMATED RECEIPTS					
Cash Sales	$ 800	$ 600	$ 700	$ 1,200	$ 2,800
Accounts Receivable	10,000	10,200	15,800	20,000	31,600
Other Income	200	400	200	480	250
Total Receipts	$11,000	$11,200	$16,700	$21,680	$34,650
ESTIMATED DISBURSEMENTS					
Accounts Payable	17,000	11,000	8,200	2,700	2,200
Payroll & Drawing	2,600	4,200	4,200	7,900	5,800
Expenses	1,200	1,800	2,000	2,700	600
Interest Expense	130	130	130	130	130
Plant & Equipment	2,500	460	600	800	100
Reserve for Taxes				3,800*	3,800*
Total Disbursements	$23,430	$17,590	$15,130	$18,030	$12,630
Estimated Excess Receipts over Disbursements	($12,430)	($ 6,390)	$ 1,570	$ 3,650	$22,020
Estimated Cash Balance at Start of Month	$ 4,200	$ 7,770	$ 1,380	$ 2,950	$ 6,600
Borrowings	$16,000				
Loan Repayment					$16,000
Estimated Cash Balance at End of Month	$ 7,770	$ 1,380	$ 2,950	$ 6,600	$12,620

* To be allotted in October and November so that available cash can be kept at the maximum during the months of heavy cash outflows.

Sound management recognizes that occasional borrowing is one of the accepted tools of America's economic system and plans with the use of this tool to avoid a "cash crisis." Your long range plan for borrowing should be based on the fact that each of the various types of money in your business has its specific and appropriate purpose.

Recognizing this fact is important in preventing the misuse of funds. Keep in mind that misuse can cause a shaky financial condition. This point is especially true when operating cash seeps into long term investment in the business. As a result, the business requires a constant renewal of short term borrowings. Such borrowing indicates a capital deficiency in the business and the need for additional permanent capital.

Bear in mind that financial planning is the prelude to effective borrowing. Such planning must be based on facts that come from your records if you are to secure loans and use them profitably.

■■■

FOR FURTHER INFORMATION

Businessmen interested in exploring further the subject of sound management and borrowing, may be interested in the following references. This list is brief and selective. However, no slight is intended toward authors whose works are not mentioned.

"Controlling Cash in Small Retail and Service Firms," *Small Marketers Aids* No. 110. Free from Small Business Administration, Washington, D.C. 20416 (or nearest SBA office).

"Is Your Cash Supply Adequate?" *Management Aids for Small Manufacturers* No. 174. Free from Small Business Administration, Washington, D.C. 20416 (or nearest SBA office).

"The ABC's of Borrowing," *Management Aids for Small Manufacturers* No. 170. Free from Small Business Administration, Washington, D.C. 20416 (or nearest SBA office).

A Handbook of Small Business Finance, SBMS No. 15. Small Business Administration. For current price write Superintendent of Documents. Washington, D.C. 20402.

Financial Statements for Bank Credit Purposes. 1964. Robert Morris Associates, Philadelphia National Bank Building, Philadelphia, Pa. 19107.

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Management Aids for Small Manufacturers
U.S. Small Business Administration

The ABC's of Borrowing

Revised by Staff Members, Financial Assistance,
Small Business Administration, Washington, D.C.

Revised April 1977

Summary

Some small businesspersons cannot understand why a lending institution refuses to lend them money. Others have no trouble getting funds, but they are surprised to find strings attached to their loans. Such owner-managers fail to realize that banks and other lenders have to operate by certain principles just as do other types of business.

This Aid discusses the following fundamentals of borrowing: (1) credit worthiness, (2) kinds of loans, (3) amount of money needed, (4) collateral, (5) loan restrictions and limitations, (6) the loan application, and (7) standards which the lender uses to evaluate the application.

Introduction

Inexperience with borrowing procedures often creates resentment and bitterness. The stories of three small businesspersons illustrate this point.

"I'll never trade here again," Bill Smith* said when his bank refused to grant him a loan. "I'd like to let you have it, Bill," the banker said, "but your firm isn't earning enough to meet your current obligations." Mr. Smith was unaware of a vital financial fact, namely, that lending institutions have to be certain that the borrower's business can repay the loan.

Tom Jones lost his temper when the bank refused him a loan because he did not know what kind or how much money he needed. "We hesitate to lend," the banker said, "to business owners with such vague ideas of what and how much they need."

John Williams' case was somewhat different. He didn't explode until after he got the loan. When the papers were ready to sign, he realized that the loan agreement put certain limitations on his business activities. "You can't dictate to me," he said and walked out of the bank. What he didn't realize was that the limitations were for his good as well as for the bank's protection.

Knowledge of the financial facts of business life could have saved all three men the embarrassment of losing their tempers. Even more important, such information would have helped them to borrow money at a time when their businesses needed it badly.

This **Aid** is designed to give the highlights of what is involved in sound business borrowing. It should be helpful to those who have little or no experience with borrowing. More experienced owner-managers should find it useful in re-evaluating their borrowing operations.

* **All names in *Aids* are disguised.**

Is Your Firm Credit Worthy?

The ability to obtain money when you need it is as necessary to the operation of your business as is a good location or the right equipment, reliable sources of supplies and materials, or an adequate labor force. Before a bank or any other lending agency will lend you money, the loaning officer must feel satisfied with the answers to the five following questions:

1. What sort of person are you, the prospective borrower? By all odds, the character of the borrower comes first. Next is his ability to manage his business.

2. What are you going to do with the money? The answer to this question will determine the type of loan—short- or long-term. Money to be used for the purchase of seasonal inventory will require quicker repayment than money used to buy fixed assets.

3. When and how do you plan to pay it back? Your banker's judgement as to your business ability and the type of loan will be a deciding factor in the answer to this question.

4. Is the cushion in the loan large enough? In other words, does the amount requested make suitable allowance for unexpected developments? The banker decides this question on the basis of your financial statement which sets forth the condition of your business and/or on the collateral pledge.

5. What is the outlook for business in general and for your business particularly?

Adequate Financial Data Is a "Must."

The banker wants to make loans to businesses which are solvent, profitable, and growing. The two basic financial statements he uses to determine those conditions are the balance sheet and profit-and-loss statement. The former is the major yardstick for solvency and the latter for profits. A continuous series of these two statements over a period of time is the principal device for measuring financial stability and growth potential.

In interviewing loan applicants and in studying their records, the banker is especially interested in the following facts and figures.

General Information: Are the books and records up-to-date and in good condition? What is the condition of accounts payable? Of notes payable? What are the salaries of the owner-manager and other company officers? Are all taxes being paid currently? What is the order backlog? What is the number of employees? What is the insurance coverage?

Accounts Receivable: Are there indications that some of the accounts receivable have already been pledged to another creditor? What is the accounts receivable turnover? Is the accounts receivable total weakened because many customers are far behind in their payments? Has a large enough reserve been set up to cover doubtful accounts? How much do the largest accounts owe and what percentage of your total accounts does this amount represent?

Inventories: Is merchandise in good shape or will it have to be marked down? How

much raw material is on hand? How much work is in process? How much of the inventory is finished goods?

Is there any obsolete inventory? Has an excessive amount of inventory been consigned to customers? Is inventory turnover in line with the turnover for other businesses in the same industry? Or is money being tied up too long in inventory?

Fixed Assets: What is the type, age, and condition of the equipment? What are the depreciation policies? What are the details of mortgages or conditional sales contracts? What are the future acquisition plans?

What Kind of Money?

When you set out to borrow money for your firm, it is important to know the kind of money you need from a bank or other lending institution. There are three kinds of money: short-term money, term money, and equity capital.

Keep in mind that the purpose for which the funds are to be used is an important factor in deciding the kind of money needed. But even so, deciding what kind of money to use is not always easy. It is sometimes complicated by the fact that you may be using some of various kinds of money at the same time and for identical purposes.

Keep in mind that a very important distinction between the types of money is the source of repayment. Generally, short-term loans are repaid from the liquidation of current assets which they have financed. Long-term loans are usually repaid from earnings.

Short-Term Bank Loans

You can use short-term bank loans for purposes such as financing accounts receivable for, say, 30 to 60 days. Or you can use them for purposes that take longer to pay off—such as for building a seasonal inventory over a period of 5 to 6 months. Usually, lenders expect short-term loans to be repaid after their purposes have been served: for example, accounts receivable loans, when the outstanding accounts have been paid by the borrower's customers, and inventory loans, when the inventory has been converted into saleable merchandise.

Banks grant such money either on your general credit reputation with an unsecured loan or on a secured loan—against collateral.

The unsecured loan is the most frequently used form of bank credit for short-term purposes. You do not have to put up collateral because the bank relies on your credit reputation.

The secured loan involves a pledge of some or all of your assets. The bank requires security as a protection for its depositors against the risks that are involved even in business situations where the chances of success are good.

Term Borrowing

Term borrowing provides money you plan to pay back over a fairly long time. Some people break it down into two forms: (1) intermediate—loans longer than 1 year but less than 5 years, and (2) long-term—loans for more than 5 years.

However, for your purpose of matching the kind of money to the needs of your company, think of term borrowing as a kind of money which you probably will pay back in periodic installments from earnings.

Equity Capital

Some people confuse term borrowing and equity (or investment) capital. Yet there is a big difference. You don't have to repay equity money. It is money you get by selling a part interest in your business.

You take people into your company who are willing to risk their money in it. They are interested in potential income rather than in an immediate return on their investment.

How Much Money?

The amount of money you need to borrow depends on the purpose for which you need funds. Figuring the amount of money required for business construction, conversion, or expansion—term loans or equity capital—is relatively easy. Equipment manufacturers, architects, and builders will readily supply you with cost estimates. On the other hand, the amount of working capital you need depends upon the type of business you're in. While rule-of-thumb ratios may be helpful as a starting point, a detailed projection of sources and uses of funds over some future period of time—usually for 12 months—is a better approach. In this way, the characteristics of the particular situation can be taken into account. Such a projection is developed through the combination of a predicted budget and a cash forecast.

The budget is based on recent operating experience plus your best judgment of performance during the coming period. The cash

forecast is your estimates of cash receipts and disbursements during the budget period. Thus, the budget and the cash forecast together represent your plan for meeting your working capital requirements.

To plan your working capital requirements, it is important to know the "cash flow" which your business will generate. This involves simply a consideration of all elements of cash receipts and disbursements at the time they occur. These elements are listed in the profit-and-loss statement which has been adapted to show cash flow in the box on page 7. They should be projected for each month.

What Kind of Collateral?

Sometimes, your signature is the only security the bank needs when making a loan. At other times, the bank requires additional assurance that the money will be repaid. The kind and amount of security depends on the bank and on the borrower's situation.

If the loan required cannot be justified by the borrower's financial statements alone, a pledge of security may bridge the gap. The types of security are: endorsers, comakers, and guarantors; assignment of leases; trust receipts and floor planning; chattel mortgages; real estate; accounts receivables; savings accounts; life insurance policies; and stocks and bonds. In a substantial number of States where the Uniform Commercial Code has been enacted, paperwork for recording loan transactions will be greatly simplified.

Endorsers, Co-makers, and Guarantors

Borrowers often get other people to sign a note in order to bolster their own credit. These **endorsers** are contingently liable for the note they sign. If the borrower fails to pay up, the bank expects the endorser to make the note good. Sometimes, the endorser may be asked to pledge assets or securities that he owns.

A co-maker is one who creates an obligation jointly with the borrower. In such cases, the bank can collect directly from either the maker or the co-maker.

A guarantor is one who guarantees the payment of a note by signing a guaranty commitment. Both private and government lenders often require guarantees from officers of corporations in order to assure continuity of effective management. Sometimes, a manufacturer will act as guarantor for one of his customers.

Assignment of Leases

The assigned lease as security is similar to the guarantee. It is used, for example, in some franchise situations.

The bank lends the money on a building and takes a mortgage. Then the lease, which the dealer and the parent franchise company work out, is assigned so that the bank automatically receives the rent payments. In this manner, the bank is guaranteed repayment of the loan.

Warehouse Receipts

Banks also take commodities as security by lending money on a warehouse receipt. Such a receipt is usually delivered directly to the bank and shows that the merchandise used as security either has been placed in a public warehouse or has been left on your premises under the control of one of your employees who is bonded (as in field warehousing). Such loans are generally made on staple or standard merchandise which can be readily marketed. The typical warehouse receipt loan is for a percentage of the estimated value of the goods used as security.

Trust Receipts and Floor Planning

Merchandise, such as automobiles, appliances, and boats, has to be displayed to be sold. The only way many small marketers can afford such displays is by borrowing money. Such loans are often secured by a note and a trust receipt.

This trust receipt is the legal paper for floor planning. It is used for serial-numbered merchandise. When you sign one, you (1) acknowledge receipt of the merchandise, (2) agree to keep the merchandise in trust for the bank, and (3) promise to pay the bank as you sell the goods.

Chattel Mortgages

If you buy equipment such as a cash register or a delivery truck, you may want to get a chattel mortgage loan. You give the bank a lien on the equipment you are buying.

The bank also evaluates the present and future market value of the equipment being used to secure the loan. How rapidly will it depreciate? Does the borrower have the necessary fire, theft, property damage, and public liability insurance on the equipment? The banker has to be sure that the borrower protects the equipment.

Real Estate

Real estate is another form of collateral for long-term loans. When taking a real estate

mortgage, the bank finds out: (1) the location of the real estate, (2) its physical condition, (3) its foreclosure value, and (4) the amount of insurance carried on the property.

Accounts Receivable

Many banks lend money on accounts receivable. In effect, you are counting on your customers to pay your note.

The bank may take accounts receivable on a notification or a nonnotification plan. Under the **notification** plan, the purchaser of the goods is informed by the bank that his account has been assigned to it and he is asked to pay the bank. Under the **nonnotification** plan, the borrower's customers continue to pay him the sums due on their accounts and he pays the bank.

Savings Accounts

Sometimes, you might get a loan by assigning to the bank a savings account. In such cases, the bank gets an assignment from you and keeps your passbook. If you assign an account in another bank as collateral, the lending bank asks the other bank to mark its records to show that the account is held as collateral.

Life Insurance

Another kind of collateral is life insurance. Banks will lend up to the cash value of a life insurance policy. You have to assign the policy to the bank.

If the policy is on the life of an executive of a small corporation, corporate resolutions must be made authorizing the assignment. Most insurance companies allow you to sign the policy back to the original beneficiary when the assignment to the bank ends.

Some people like to use life insurance as collateral rather than borrow directly from insurance companies. One reason is that a bank loan is often more convenient to obtain and usually may be obtained at a lower interest rate.

Stocks and Bonds

If you use stocks and bonds as collateral, they must be marketable. As a protection against market declines and possible expenses of liquidation, banks usually lend no more than 75 percent of the market value of high grade stock. On Federal Government or municipal bonds, they may be willing to lend 90 percent or more of their market value.

The bank may ask the borrower for additional security or payment whenever the market value of the stocks or bonds drops below the bank's required margin.

What Are the Lender's Rules?

Lending institutions are not just interested in loan repayments. They are also interested in borrowers with healthy profit-making businesses. Therefore, whether or not collateral is required for a loan, they set loan limitations and restrictions to protect themselves against unnecessary risk and at the same time against poor management practices by their borrowers. Often some owner-managers consider loan limitations a burden.

Yet others feel that such limitations also offer an opportunity for improving their management techniques.

Especially in making long-term loans, the borrower as well as the lender should be thinking of: (1) the net earning power of the borrowing company, (2) the capability of its management, (3) the long range prospects of the company, and (4) the long range prospects of the industry of which the company is a part. Such factors often mean that limitations increase as the duration of the loan increases.

What Kinds of Limitations?

The kinds of limitations, which an owner-manager finds set upon the company depends, to a great extent, on the company. If the company is a good risk, only minimum limitations need be set. A poor risk, of course, is different. Its limitations should be greater than those of a stronger company.

Look now for a few moments at the kinds of limitations and restrictions which the lender may set. Knowing what they are can help you see how they affect your operations.

The limitations which you will usually run into when you borrow money are:

(1) Repayment terms.
(2) Pledging or the use of security.
(3) Periodic reporting.

A loan agreement, as you may already know, is a tailor-made document covering, or referring to, all the terms and conditions of the loan. With it, the lender does two things: (1) protects his position as a creditor (he wants to keep that position in as well a protected

state as it was on the date the loan was made) and (2) assures himself of repayment according to the terms.

The lender reasons that the borrower's business should **generate enough funds** to repay the loan while taking care of other needs. He considers that cash inflow should be great enough to do this without hurting the working capital of the borrower.

Covenants—Negative and Positive

The actual restrictions in a loan agreement come under a section known as covenants. Negative covenants are things which the borrower may not do without prior approval from the lender. Some examples are: further additions to the borrower's total debt, nonpledge to others of the borrower's assets, and issuance of dividends in excess of the terms of the loan agreement.

On the other hand, positive covenants spell out things which the borrower must do. Some examples are: (1) maintenance of a minimum net working capital, (2) carrying of adequate insurance, (3) repaying the loan according to the terms of the agreement, and (4) supplying the lender with financial statements and reports.

Overall, however, loan agreements may be amended from time to time and exceptions made. Certain provisions may be waived from one year to the next with the consent of the lender.

You Can Negotiate

Next time you go to borrow money, thrash out the lending terms before you sign. It is good practice no matter how badly you may need the money. Ask to see the papers in advance of the loan closing. Legitimate lenders are glad to cooperate.

Chances are that the lender may "give" some on the terms. Keep in mind also that, while you're mulling over the terms, you may want to get the advice of your associates and outside advisors. In short, try to get terms which you know your company can live with. Remember, however, that once the terms have been agreed upon and the loan is made (or authorized as in the case of EBA), you are bound by them.

The Loan Application

Now you have read about the various aspects of the lending process and are ready to apply for a loan. Banks and other private lending institutions, as well as the Small Business Administration, require a loan application on which you list certain information about your business.

For purposes of explaining a loan application, this **Aid** uses the Small Business Administration's application for a loan (SBA Form 4). The SBA form is more detailed than most bank forms. The bank has the advantage of prior knowledge of the applicant and his activities. Since SBA does not have such knowledge, its form is more detailed. Moreover, the longer maturities of SBA loans ordinarily will necessitate more knowledge about the applicant.

Before you get to the point of filling out a loan application, you should have talked with an SBA representative, or perhaps your accountant or banker, to make sure that your business is eligible for an SBA loan. Because of public policy, SBA cannot make certain types of loans. Nor can it make loans under certain conditions. For example, if you can get a loan on reasonable terms from a bank, SBA cannot lend you money. The owner-manager is also not eligible for an SBA loan if he can get funds by selling assets which his company does not need in order to grow.

When the SBA representative gives you a loan application, you will notice that most of its sections ("Application for Loan"—SBA Form 4) are self-explanatory. However, some applicants have trouble with certain sections because they do not know where to go to get the necessary information.

Section 3—"Collateral Offered" is an example. A company's books should show the net value of assets such as business real estate and business machinery and equipment. "Net" means what you paid for such assets less depreciation.

If an owner-manager's records do not contain detailed information on business collateral, such as real estate and machinery and equipment, he sometimes can get it from his Federal income tax returns. Reviewing the depreciation which he has taken for tax purposes on such collateral can be helpful in arriving at the value of these assets.

If you are a good manager, you should have your books balanced monthly. However, some businesses prepare balance sheets less regularly. In filling out your "Balance Sheet as of _____, 19__, Fiscal Year Ends _____," remember that you must show the condition of your business within 60 days of the date on your loan application. It is best to get expert advice when working up such vital information. Your accountant or banker will be able to help you.

Again, if your records do not show the

details necessary for working up profit and loss statements, your Federal income tax returns (Schedule C of Form 1040, if your business is a sole proprietorship or a partnership) may be useful in getting together facts for the SBA loan application.

Insurance

SBA also needs information about the kinds of insurance a company carries. The owner-manager gives these facts by listing various insurance policies. If you place all your insurance with one agent or broker, you can get this information from him.

Personal Finances

SBA also must know something about the personal financial condition of the applicant. Among the types of information are: personal cash position; source of income including salary and personal investments; stocks, bonds, real estate, and other property owned in the applicant's own name; personal debts including installment credit payments, life insurance premiums, and so forth.

Cash Budget

(for three months, ending March 31, 19__)

	January		February		March	
	Budget	Actual	Budget	Actual	Budget	Actual
Expected Cash Receipts:						
1. Cash sales						
2. Collections on accounts receivable						
3. Other income						
4. Total cash receipts						
Expected Cash Payments:						
5. Raw materials						
6. Payroll						
7. Other factory expenses (including maintenance)						
8. Advertising						
9. Selling expense						
10. Administrative expense (including salary of owner-manager)						
11. New plant and equipment						
12. Other payments (taxes, including estimated income tax; repayment of loans; interest; etc.)						
13. Total cash payments						
14. **Expected Cash Balance** at beginning of the month						
15. Cash increase or decrease (item 4 minus item 13)						
16. Expected cash balance at end of month (item 14 plus item 15)						
17. Desired working cash balance						
18. Short-term loans needed (item 17 minus item 16, if item 17 is larger)						
19. Cash available for dividends, capital cash expenditures, and/or short term investments (item 16 minus item 17, if item 16 is larger than item 17)						
Capital Cash:						
20. Cash available (item 19 after deducting dividends, etc.)						
21. Desired capital cash (item 11, new plant equipment)						
22. Long-term loans needed (item 21 less item 20, if item 21 is larger than item 20)						

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Evaluating the Application

Once you have supplied the necessary information, the next step in the borrowing process is the evaluation of your application. Whether the processing officer is in a bank or in SBA, he considers the same kinds of things when determining whether to grant or refuse the loan. The SBA loan processor looks for:

(1) The borrower's debt paying record to suppliers, banks, home mortgage holders, and other creditors.

(2) The ratio of the borrower's debt to his net worth.

(3) The past earnings of the company.

(4) The value and condition of the collateral which the borrower offers for security.

The SBA loan processor also looks for: (1) the borrower's management ability, (2) the borrower's character, and (3) the future prospects of the borrower's business.

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